

***United States Court of Appeals
for the Second Circuit***



**APPELLANT'S
REPLY BRIEF**

74-2582

United States Court of Appeals
For the Second Circuit

ROSALIND FOGEL, *et ano.*,

Plaintiffs-Appellants,

versus

GEORGE A. CHESTNUTT, JR., *et al.*,

Defendants-Appellees.

REPLY BRIEF FOR PLAINTIFFS-APPELLANTS

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REPLY BRIEF FOR PLAINTIFFS-
APPELLANTS

Summary of Contentions

Because the answering brief of defendants-appellees does not deal with most of plaintiffs' principal contentions, it may be useful to summarize them briefly here. In our main brief, we argued that the defendants were under a duty to recapture brokerage commissions

for the Fund, if possible. Their liability rests on two alternative bases. First, as fiduciaries, the Management Co. defendants were obliged to inform the independent directors of the possibility of recapture. This they failed to do, although they were fully aware of the availability of recapture. Second, the Fund's charter mandates recapture if possible (Main Br., pp. 20-26).

Plaintiffs-appellants also argued that substantial recapture was available both through NASD membership and membership on the PBW exchange. Neither of these required any substantial alteration in the defendants' method of doing business and neither was in contravention of public policy (Main Br., pp. 26-57).

Finally, we argued (Main Br., pp. 57-60) that, even in the absence of recapture, the Fund's Investment Advisory Agreement forbade the use of reciprocal brokerage and give-ups to promote sales of Fund shares.

P O I N T I

DEFENDANTS WERE UNDER A DUTY TO RE-
CAPTURE BROKERAGE COMMISSIONS FOR
THE FUND, IF POSSIBLE.

Defendants' duty to recapture brokerage commissions resulted both from the Fund charter and from defendants' fiduciary status.

A. Defendants' Fiduciary Duties

The fiduciary aspect of defendants' obligations came from their positions as directors and as the investment adviser of the Fund (Main Br., pp. 20-21). That fiduciary obligation - or, more accurately, the breach thereof - was highlighted by the defendants' use of the Fund's brokerage commissions to benefit themselves. They stimulated the sale of Fund shares (which increased Management Co.'s advisory income) by directing give-ups and reciprocals to brokers who promoted the sale of Fund shares. They also obtained research information by directing Fund

commissions to brokers who furnished Management Co. with research and statistical data.

Defendants appear to contend that they did not in fact direct brokerage commissions to brokers who sold Fund shares or provided research (Defs.' Br., pp. 10-13). Sales of fund shares are said to have resulted instead from "radiation" (id., p. 4). This apparent contention* directly conflicts with the finding of the lower court (335a):

"...there is no question but that the Adviser, acting for Fund, directed reciprocals and give-ups to brokers who sold Fund shares or who gave research material to the Adviser or both."

See also 335a-336a. It also conflicts with the defendants' own testimony (92a-95a) and their documents (153a, 155a, 161a, 176a). Their disavowal is, thus, baseless.

*We refer to the contention as "apparent" because it is by no means clear. Indeed, without regard for consistency, defendants argue that stimulation of sales with brokerage commissions was desirable (Defs.' Br., pp. 8-9).

Defendants' fiduciary obligation to inform the Fund's independent directors of the avenues of recapture follows from defendants' knowledge of its availability. They contend, however, that they were unaware of the possibility of recapture (Defs.' Br., pp. 19-23). This, again, is utterly refuted by their own testimony (Main Br., p. 21; 82a, 227a, 231a, 238a, 240a; Ex. 23, pp. 26-28; Ex. 26, pp. 138-39*). At least as early as October 1967, defendant Chestnutt knew that "You could do it [recapture] by devious methods as were described earlier, becoming an NASD member and directing business to your subsidiary..." (^{237a,} ~~237a,~~ 238a).

Although they knew of the availability of recapture, defendants apparently seek to mitigate the effect of this knowledge by asserting that counsel advised them not to

*We apologize to the Court for an inaccurate record reference in our main brief. The reference at p. 21 to pp. 223a-236a should have been to Exhibits 23 and 26 at the above cited pages, where Greene and Sabel testified that they were aware of the recapture suggestions made by the SEC in 1968, but that Sabel advised the unaffiliated directors that they did not apply to the Fund.

recapture (Defs.' Br., p. 20). For several reasons, advice of counsel is not a defense available to the Management Co. defendants.

First, the advice was rendered by Sabel, who had a substantial economic interest in Management Co. (Main Br., pp. 5,6; 26a, 27a)*. If recapture was found to be feasible, Management Co. would lose the benefits it was deriving from give-ups and reciprocals. Mr. Sabel thus had a substantial motive to rule out recapture. Because of this conflict of interests, Mr. Chestnutt, as the President of the Fund, and the other officers of the Fund, had no right to rely on Mr. Sabel's advice.

Second, the "advice" was of a casual and informal nature. No written opinion was secured (96a-99a). No investigation was requested or undertaken (83a, 96a-99a, 110a). Sabel merely advised Chestnutt, "shoemaker stick to your last." (Defs.' Br., p. 20). In the face of defendants'

*Mr. Lee, with the same conflict of interests, rendered similar advice.

actual knowledge of the existence of recapture and of the SEC's official recapture urgings (e.g., 141a, 146a-147a, 259a), defendants could not justifiably rely upon a casual oral expression of counsel.

Finally, a fiduciary who profits from his office must surrender his gains; belief in his counsel's advice is not a defense; Wilshire Oil Co. v. Riffe, 381 F.2d 646, 651-52 (10th Cir. 1967), cert. den. 389 U.S. 822; Fleishacker v. Blum, 109 F.2d 543, 545-46 (9th Cir. 1940), cert. den. 311 U.S. 665. Plainly, a fiduciary cannot keep his cestui's moneys on the plea that he thought they were his.

The defendants devote six pages of their answering brief (pp. 13-19) to a description of the unaffiliated directors. Apparently they seek to draw the conclusion that the unaffiliated directors were opposed to involvement in brokerage business and that, therefore, the Management Co. defendants did not breach their fiduciary duty. If this is defendants' argument, it completely misses the mark.

As pointed out in our Main Brief (p. 22), the Management Co. defendants and their counsel advised the unaffiliated directors that, without going into a full-scale brokerage operation, recapture for the Fund was impossible. "Stanley Sabel said this [recapture] was clearly out of the question as far as the fund is concerned." (97a). See also 30a, 268a-272a. The unaffiliated directors, who were by and large unfamiliar with the securities brokerage industry, believed the advice given them by Management Co. (108a-110a, 118a-121a, 249a, 321a). They did not seek outside advice (121a, 246a-248a, 321a). Thus, they never knew that recapture was available without substantially changing the operations of the Fund or Management Co.* On the contrary, they were led to believe that recapture would require a substantial change (108a-110a, 118a-121a, 249a, 321a). This advice was contrary to the fact. For,

*Indeed, had they known, they might well have favored recapture (120a-121a).

recapture, either through NASD membership or PBW membership, was available without any such alteration (Main Br., pp. 27-49).

Accordingly, any aversion of the unaffiliated directors against engaging in a full-scale brokerage operation is beside the point. As the court held in Moses v. Burgin, 445 F.2d 369, 376 (1st Cir. 1971), cert. den. sub nom Johnson v. Moses, 404 U.S. 994:

"...We think the conclusion unavoidable that Management defendants were under a duty of full disclosure of information to these unaffiliated directors in every area where there was even a possible conflict of interest between their interests and the interests of the fund."

For failure to advise the unaffiliated directors of the availability of recapture, the court in Moses held the Management defendants liable for breach of their fiduciary duties. The Management Co. defendants here are similarly liable for breach of their fiduciary duties.

B. The Fund Charter

Even if defendants could establish that they did

not have a fiduciary obligation to effect recapture, the Fund's Certificate of Incorporation nevertheless required the recapture of brokerage commissions where possible. As shown, the Fund's charter independently mandates recapture (Main Br., pp. 24-26). Defendants do not dispute this.

P O I N T I I

SUBSTANTIAL AMOUNTS OF THE FUND'S BROKERAGE COMMISSIONS WERE RECAPTURABLE

A. Recapture Through PBW Membership

In our main brief, we showed that, contrary to the lower court, membership on the PBW exchange was not precluded by public policy (pp. 50-57). Defendants' only reply to this contention is reliance upon a statute enacted in June, 1975 (the Securities Acts Amendments of 1975, Defs.' Br., pp. 34-36), which, beginning on May 1, 1978, precludes exchange members from executing transactions for affiliated accounts (§ 6, amending § 11 of the Securities Exchange Act of 1934). As pointed out in our main brief (p. 54), the advent of fully

negotiated rates on May 1, 1975, made unnecessary so-called institutional membership. The purpose of membership on the PBW would have been to reduce fixed commissions. It is clear that the Congress equated fully negotiated rates and institutional membership (300a). Thus, it is perfectly consistent for Congress to restrain institutional membership once fixed commissions had been abolished. The legislation, which abolishes fixed commission rates (§ 4, amending § 6 of the Exchange Act), must be viewed as a vindication, not a repudiation, of the policy favoring recapture.

Defendants also contend that PBW membership would have involved a change in the nature of their business and would have required membership in the NASD (pp. 24-25). This is in direct conflict with the testimony of Elkins Wetherill, President of the PBW exchange, a disinterested witness, who testified as to the availability of introducing membership, and specifically testified that NASD

membership was not necessary (54a-58a, 65a-66a, 71a-72a).*

Defendants further claim that the Moses case affirmatively held that mutual fund advisers have no obligation to seek exchange membership (pp. 33-34). As we pointed out in our main brief (pp. 41-42), Moses v. Burgin expressly held open the possibility for introducing membership where plaintiffs are able to prove its availability. Introducing membership on the PBW was clearly available here. It did not involve any alteration in the defendants' method of doing business. Accordingly, in the facts of this case, the defendants had the obligation to seek such membership on the same principles which required recapture in Moses. Frankel v. Hyde, CCH Fed. Sec. L. Rep. ¶ 94,486 (S.D.N.Y. 1974).

*71a-72a, where Mr. Wetherill testified that NASD membership was not necessary, are incorrectly referenced at p. 47 of our main brief as 171a-172a.

B. Recapture Through
NASD Membership

Defendants also contend that NASD membership would have entailed a substantial alteration in their method of doing business; namely, the active carrying on of a general brokerage business with the incurring of substantial expenses (Defs.' Br., pp. 20-24). Defendants offer no substantiation for this contention other than their own assertions. However, as we have shown (Main Br., pp. 27-34), the rules of the NASD itself, supported by the testimony of the NASD general counsel, permitted NASD membership. Defendants' disclaimers are hardly probative.

C. Amounts Recapturable

Defendants contend that, in any event, the amounts recapturable were small. There is, however, no evidence on this point, since the Court severed the issues of liability and damage (325a). We might point out that the brokerage

commissions involved here ran to many millions of dollars (153a, 155a), and that substantial percentages of those commissions were recapturable (51a, 60a, 216a). Indeed, substantial recapture was effected by many other funds (e.g., \$4,100,000 in 1967 by I.D.S. (29a), \$1,203,000 in 1970 by the Dreyfus Fund (Ex. 36, pp. 5, 9; see also Ex. 29, p. 15; Ex. 30, pp. 8-9; Ex. 31, p. 14; Ex. 33, p. 5; Ex. 34, p. 6; and Ex. 35, p. 6)).

P O I N T I I I

DEFENDANTS ARE LIABLE FOR VIOLATING THE INVESTMENT ADVISORY AGREEMENT.

As we have shown, the Investment Advisory Agreement expressly forbade the defendants from using the Fund's brokerage to promote sale of Fund shares (pp. 57-60). Defendants do not dispute this. Since they did so use the Fund's brokerage, they cannot escape liability.

P O I N T I V

DEFENDANTS, AS FIDUCIARIES, BEAR
THE BURDEN OF PROOF AS TO ALL ASPECTS
OF THEIR DEALINGS WITH THE FUND.

On all of the foregoing issues, defendants recognize - as we argued in our main brief (pp. 34-35), - that they had the burden of proof, at least as to events occurring prior to June 15, 1972 (Defs.' Br., p. 35). They claim that as to subsequent events, the amendment of § 36(b) of the Investment Company Act shifted the burden of proof to the plaintiff. Since all of the operative events giving rise to the Fund's damage occurred prior to June 1972 (Main Br., pp. 20-26), the amendment is not significant here.

P O I N T V

THE ABSENCE OF A DEMAND UPON THE
BOARD OF THE FUND TO INSTITUTE THIS
ACTION WAS JUSTIFIABLY EXCUSED.
DEFENDANTS MAY NOT RAISE IT AT THIS
POINT.

For the first time, defendants claim on this appeal that plaintiffs did not justifiably excuse their

lack of demand on the Board of Directors to bring this action. The point is without merit.

1. While ordinarily a district court judgment may be sustained on any ground finding support in the record, the rule does not apply where the appellee has expressly abandoned his theory in the district court. Helvering v. Salvage, 297 U.S. 106, 109 (1936); Virginian R. Co. v. Mullens, 271 U.S. 220, 227-28 (1926):

"After bringing and trying the case on [one] theory the plaintiff cannot be permitted on this review to change to another which the defendant was not required to meet below....

.....

"Judgment reversed."

See also Reliford v. Eastern Coal Corp., 260 F.2d 447, 457 (6th Cir. 1958).

The present case went to trial on issues and contentions spelled out at length by the parties and the court below in the pre-trial order (25a-43a). Nowhere in that pre-trial order do defendants claim the defense urged for

the first time here.* To permit defendants to raise the issue here would defeat the very purpose of the pre-trial order and of Rule 16 FRCP, which provides that "such order when entered controls the subsequent ^{course} ~~course~~ of the action". Under similar circumstances, this Court has refused to permit an appellee to obtain an affirmance on a theory abandoned below; North American Leisure Corp. v. A & B Duplicators, Ltd., 468 F.2d 695, 699 (2d Cir. 1972).

2. Moreover, the defense of lack of demand relates to the manner in which the corporation - here the Fund - chooses to press its claim. If the Fund waives the defense, a third party may not insist upon it; Schy v. Franklin National Bank, 72-C-718, pp. 10-11 (E.D.N.Y., Feb. 19, 1974; Judd, J.):

*Nor do defendants urge that defense in their answer (15a-23a).

"There is a real question whether the alleged wrongdoer has a right to object to a stockholder plaintiff's failure to make a satisfactory demand on the corporation. In Ripley v. International Railways of Central America, 8 A.D. 2d 310, 188 N.Y.S. 2d 62, 72 (1st Dept. 1959), the court said that the alleged wrongdoer ought not to be able to dictate who shall sue him."

In the Ripley case referred to by Judge Judd, the court states (188 N.Y.S. 2d at 72):

"Certainly, the alleged wrongdoer ought not to be able to dictate whether the injured corporation or minority stockholders in a derivative capacity should bring the suit. Koral v. Savory, Inc., 276 N.Y. 215, 11 N.E. 2d 883."

Here the Fund has not asserted the demand defense, or indeed any defense. Its answer simply states "that it submits its rights to the Court and asks the Court to make such judgment and decree herein with respect to said defendants as may be just and proper (24a). Accordingly, the wrongdoing defendants may not raise the defense.

3. In any event, the plaintiff was justified in foregoing a demand upon the directors. Demand upon directors

is always excused when a majority of the Board has an economic interest in the transactions challenged. When the directors "stand in a dual relation which prevents an unprejudiced exercise of judgment", demand upon them to sue themselves is not required; United Copper Securities Co. v. Amalgamated Copper Co., 244 U.S. 261, 264 (1917). Accord: Delaware & Hudson Co. v. Albany & Susquehanna R. Co., 213 U.S. 435, 451 (1909); Liboff v. Wolfson, 437 F.2d 121, 122 (5th Cir. 1971); Cathedral Estates, Inc. v. Taft Realty Corp., 228 F.2d 85, 88 (2nd Cir. 1955); Papilsky v. Berndt, 59 F.R.D. 95, 97 (S.D.N.Y. 1973), app. dismiss., 503 F.2d 554 (2d Cir. 1974), cert. den. ____ U.S. ____; Barr v. Wackman, 36 N.Y.2d ____ (April 1, 1975).* Here, the Fund never had a majority of directors

*None of the cases cited by defendants disputes this proposition. Greenspan v. Lindley, N.Y.L.J., May 19, 1975, p. 1, which defendants claim is dispositive (Defs.' Br., p. 3ln.), specifically affirms this proposition (p. 5). However, since that case involved Massachusetts law it is not germane.

untainted by an economic interest in Management Co.

Defendants argue that, at the time the action was commenced, only three of the seven Fund directors were "affiliated" with Management Co. (Defs.' Br., pp. 13, 27). However, a fourth director, Currier, owned 2% of the stock of Management Co. (27a). Although he was not technically "affiliated" with it under the definition of the Investment Company Act*, his economic interest was so substantial that he could not be expected to diligently prosecute an action against Management Co. Accordingly, four of the seven directors stood in "a dual relation".** It would have been futile to request a majority of the directors to institute suit against their own interests.

*Under § 2(a)(3) of the Act, "affiliation" requires 5% stock ownership.

**The court below stated that Currier "is counted as an affiliated director" because of his stock in Management Co. (328a).

C O N C L U S I O N

The judgment below should be reversed and the case remanded for a determination of the damages and profits to be recovered for the Fund.

Respectfully submitted,

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Dated: New York, N. Y.
July 8, 1975

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Service of ^{two}~~three~~ copies of the within
is admitted this 9th day of July 1975

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